Finding the elusive cap rate in the coronavirus pandemic environment

BY PETER F. KORPACZ, MAI, CRE, FRICS

Finding the elusive cap rate in the real estate transaction market after the coronavirus pandemic is the biggest challenge commercial appraisers will face in coming months.

And it permeates the entire global appraisal profession.

The solution to the challenge is rooted in traditional appraisal methodologies and is, in fact, right under our collective noses.

Active/potential sellers and buyers have always been the source of cap rates and this reality has not changed.

If anyone truly knows cap rates it is those who are actively seeking to dispose or invest in commercial real estate assets. Even if some potential sales do not materialize because there is no meeting of the minds, the potential sellers and buyers know their cap-rate comfort level.

In those situations, the truth is likely somewhere within the bid/ask gap.

But how do appraisers support their appraisals when there are few, if any, actual sale transactions?

Taking the pulse of active/potential sellers and buyers has always been the hallmark of good appraisal research, and it has not changed just because the market is distressed.

Appraisers will continue to research, verify, and use the likely limited number of current sales but may find themselves with too few cap rate data points to reasonably support their conclusions.

Here's the solution!

Go back to comparables that are dated, maybe within one to two years before a valuation date.

Reconnect with participants to those transactions and get their input on how they would do the same transactions on the appraiser's current date of value using the same property, same historical performance characteristics, existing leases, etc., but in a different economy and leasing and capital market conditions.

The essential questions are how would you underwrite the deal and what cap rate would likely result as of the appraiser's valuation date?

In doing this, the appraiser does not "create new comparable sales," but instead completes a highly targeted local "investor survey" of transaction participants who have already invested in the local market and are quite familiar with historical and current conditions.

This method of extracting useful, supportable current cap rates takes the place of reasoning to a current cap rate using older sales with some narrative discussion of how distressed economic and real estate market conditions lead the appraiser to conclude with a higher cap rate of X.

What would the appraiser's client prefer and what would be more accurate? The appraiser's opinion supported by the opinion of seasoned investors in the local market, or the appraiser's subjective opinion based on broad references to distressed economic and real estate market conditions.

The answer is obvious.

The technique described above may be new to many appraisers, but I and a few others have been using it since the 2001 recession whenever there is a dearth of current comparable sale transactions.

It reflects standard appraisal methodology, which is based on getting to investors "in the know," "taking their pulse," and "picking their brains" to support valuation assumptions and conclusions.

What could be more normal for an appraiser?

PETER F. KORPACZ is founder and president of Korpacz Realty Advisors